Economic Outlook

Irving Trust

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The recent spectacular surge in stock prices has raised an inevitable question: Will the economy accelerate this year to justify the market rally? Some acceleration is indeed expected in our forecast. Real GNP is projected to rise 3.5% from the fourth quarter of last year to the fourth quarter of this year, compared to an increase of 2.2% in 1986.

A narrowing trade deficit is the key to the expected acceleration. After a long time lag, the effect of a sharply lower dollar has finally begun to be felt. The non-oil trade deficit in real terms shrank in the last two quarters of 1986. Further reductions are expected this year. Export growth should be strong, while the increase in imports is likely to be slowed by higher import prices. Consumer expenditures are expected to continue to provide support for the economy. Although the high debt burden may restrain spending somewhat, the reduction in personal income taxes (due to tax reform) and the wealth effect (resulting from the stock market rally) should be more than enough to offset this drag. When the Tax Reform Act was passed, the reduction in individual income taxes was estimated to be $14 billion in 1987, a cut of nearly 4%. Furthermore, the effect of the tax cut is likely to be augmented by underwithholding, at least initially. The withholding schedule is geared to the new law's lower rates and larger exemptions, but probably does not fully take into consideration the elimination of many deductions and credits. As a result, people may get a tax cut larger than they should in their paychecks this year. Of course, they will owe the difference when they file their returns in April 1988.

Fiscal restraint and lackluster business investment will be the major drags on the economy this year. About a $50 billion reduction in the Federal deficit is currently expected this year by both the OMB and the CBO. This could lower real GNP growth by about 1% compared to what it otherwise would be. Moreover, a recent survey indicates that the business sector plans no real increase in capital spending this year. Investment in commercial properties, already beset by overbuilding, will be hit hard by tax reform. Although the collapse of oil drilling activities is behind us, a meaningful rebound in this sector seems unlikely this year. In general, the loss of the investment tax credit has in effect raised the price of capital equipment by 10%. Therefore, some previously marginally profitable investment projects may now be scratched.

The sluggish pace of economic growth since mid-1984 has indeed caused pain in certain areas. The unemployment rate has changed little during this period, while the industrial sector has essentially moved sideways. Nonetheless, the sluggishness has some positive aspects. The economic recovery, which began in late 1982, has now entered its fifth year. Normally, labor shortages, capacity constraints, and upward pressure on interest rates would be evident after so many years of economic expansion. These factors would normally slow the economy, and eventually a contraction would ensue. The economy faces none of these constraints right now: The rise in labor costs remains moderate, the capacity utilization rate indicates slack still exists, and only a moderate increase in interest rates is expected this year. As a result, the economy still has plenty of room for further expansion.

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Economic Forecast

Percent Changes at Annual Rates

	Actual 1986 I	II	III	IV	Forecast 1987 I	II	III	IV	Actual 1984-1985	1985-1986	Forecast 1986-1987
Gross National Product	6.2	2.6	6.4	2.6	7.4	8.3	8.4	7.7	6.2	5.3	6.4
Real GNP	3.8	0.6	2.8	1.7	3.3	4.1	3.8	2.7	2.7	2.5	2.9
GNP Price Deflator	2.5	1.8	3.6	1.0	4.0	4.0	4.5	4.9	3.3	2.7	3.3

	Actual 1986: IV	Forecast 1987: I	Actual 1984-1985	1985-1986	Forecast 1986-1987
Consumer Spending	2.9%	6.3%	7.1%	6.2%	6.5%
Durable Goods	-9.6	-8.0	8.5	8.1	3.7
Nondurable Goods	3.1	10.7	4.0	3.0	6.5
Services	6.6	7.6	8.9	7.9	7.2
Business Capital Spending	-0.8	0.5	10.0	0.1	1.5
Structures	-2.6	0.3	11.1	-7.2	-3.1
Equipment	0.0	0.6	9.4	3.8	3.6
Residential Investment	6.1	9.0	5.7	12.9	7.7
			1985	1986	1987
Change in Inventories	$-8.3b.	$20.0b.	$11.1b.	$11.4b.	$25.3b.
Net Exports of Goods and Services	$-115.6b.	$-113.0b.	$-78.9b.	$-105.7b.	$-96.9b.
			1984-1985	1985-1986	1986-1987
Government Purchases	7.4%	-1.2%	11.2%	6.1%	5.1%
Federal	7.8	-12.6	13.7	3.7	1.7
Defense	-6.7	4.3	10.4	7.3	4.5
Other	70.6	-51.2	24.3	-6.1	-6.9
State & Local	7.0	7.9	9.3	8.0	7.5
Corporate Profits Before Tax	8.5*F	17.2*	-5.3	6.0F	12.7
Corporate Profits After Tax	3.0*F	16.1*	-6.3	1.8F	12.6
Plant and Equipment Expenditures	1.8F	1.2	9.2	-2.8F	1.8
Real Final Sales#	3.0	0.0	4.2	2.5	2.6
Real Disposable Personal Income	-0.5	4.6	2.3	3.0	2.7

Economic Indicators	Recent Data Oct.	Nov.	Dec.	Actual 1984-1985	1985-1986	Forecast 1986-1987
Consumer Price Index**	2.4%	3.6%	2.4%	3.7%	1.1%	4.8%
Producer Price Index for Finished Goods**	3.6	2.4	0.0	1.8	-2.5	4.0
Industrial Production	3.6	7.2	6.0	2.2	1.0	2.5
Retail Sales#**	-5.2	-0.6	4.4	6.4	5.2	5.3
				1985	1986	1987
Auto Sales (millions of units, a.r.)	10.3	10.5	13.6	11.0	11.5	10.7
Housing Starts (millions of units, a.r.)	1.63	1.59	1.80	1.74	1.81	1.66
Unemployment Rate	6.9%	6.9%	6.7%	7.2%	7.0%	6.4%
Merchandise Trade Deficit (a.r.)	$-176.6b.	$-185.3b.	$-127.9b.	$-139.7b.	$-169.8b.	$150.0b.

Unless noted otherwise, all data are period-to-period percent changes at annual rates, derived from seasonally adjusted data.

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#GNP less change in inventories, both in real terms.
##Monthly percent changes are not annualized.
*Year-over-year percent changes.
**Annual percent changes are December to December (not seasonally adjusted).
$b. = billions a.r. = annual rate F = Forecast